United States General Accounting Office

GAO

Report to the Commander, U.S. Air Force Aeronautical Systems Division

COMP...
12

January 1988

CONTRACT PRICING

Overpricing B-1 Engine Fan Blade Subcontract

GAO/NSIAD-88-100

ORIGINAL

GAO

United States
General Accounting Office
Washington, D.C. 20548

Boston Regional Office **10 Causeway Street, Room 575**
Boston, MA 02222

B-219741

January 28, 1988

Lieutenant General William Thurman, Commander
Air Force Aeronautical Systems Division
Wright-Patterson Air Force Base, Ohio 45433

Dear General Thurman:

We have completed a review of subcontract pricing at Mal Tool & Engineering, Manchester, Connecticut, a division of Wickes Companies, and formerly a division of Gulf & Western Industries. We examined Mal Tool's 1984 subcontract with the General Electric Company, Aircraft Engine Business Group, under the Air Force's firm-fixed price contract F33657-84-C-2047. This is a multi-year subcontract under which Mal Tool supplies fan blades for the B-1 bomber engine manufactured by General Electric.

We assessed whether Mal Tool included unallowable overhead costs in its subcontract proposal to General Electric. We found that Mal Tool's overhead costs included expenses associated with a 44-foot yacht, a lodge in a ski area, entertainers in a hotel hospitality suite, a product display exhibit, and contributions and donations. Most of these costs were listed as promotional expenses in its accounting records. We believe that such items are unallowable under federal regulations and should not have been included in the overhead rate used in preparing its subcontract proposal to General Electric. Detailed information on these costs is presented in appendix I.

General Electric's analysis of Mal Tool's proposal did not identify any of these unallowable costs and, consequently, it included them in the cost or pricing data supporting material prices given to the Air Force. We, therefore, believe that this contract was overpriced by $190,646, including General Electric's overhead and profit.

Mal Tool officials contend that most of the costs we questioned were allowable. They maintain that cost items, such as the yacht and the ski lodge, were employee benefit expenses that were misclassified in its accounting records as sales promotion. They further contend that other costs listed as promotional expenses were allowable because the government benefited from functions where Mal Tool displayed its products to various groups including government personnel. They agreed that some of the costs charged as contributions were not allowable. Mal Tool officials stated that they were in the process of revising the company's

internal controls to ensure that unallowable costs are not included in government subcontract proposals.

Although Mal Tool asserts that the yacht and lodge were employee morale expenses, it could not provide us with a written policy for employee use of these facilities. Mal Tool also could not document which company personnel actually used the yacht and lodge, or for what purposes. Mal Tool could only estimate that the yacht and lodge, which cost $134,017 for one year, were used about ten times by Mal Tool employees and employees of its parent company.[1] In addition, because of the infrequent use made of these facilities, the costs associated with them do not appear to be reasonable, as required by regulation, even if made for employee morale purposes.

General Electric officials did not disagree or agree with our views on the allowability of individual cost items. They stated that after the government contracting officer's determination is made on the amount of unallowable costs, the company would make an offer of a voluntary refund to resolve this issue.

We believe the information in this report provides a basis for you to initiate action to recover funds from General Electric, and we recommend you take such action. Because we believe that Mal Tool may have charged the same costs as discussed here, on other government contracts with General Electric and possibly other prime contractors, we also recommend that you determine if other Mal Tool subcontracts are priced on the same cost basis and, if so, initiate action to recover any amounts improperly charged. For example, we identified an additional $3.2 million of Mal Tool subcontract purchases for the B-1 bomber engine that were negotiated at the same time as the subcontract we reviewed.

Copies of this report are being sent to the Secretaries of Defense and Air Force; the President of Mal Tool & Engineering, Manchester, Connecticut; the Vice-President of the General Electric Aircraft Engine Business Group, Evendale, Ohio; the Commander, Air Force Plant Representative Office, Detachment 28, Evendale, Ohio; the Commander, Defense Contract Administration Management Area, Hartford, Connecticut; and the Regional Director, Defense Contract Audit Agency, Waltham, Massachusetts. Copies will also be furnished to others upon request. If you or

[1] Insofar as the parent company's employees use of the yacht and lodge, costs associated with the facilities appear to be unallowable entertainment expenses (DAR 15-205.11).

your staff need additional information, please call me or Mr. Paul Greeley on (617) 565-7467.

Sincerely yours,

Morton A. Myers
Regional Manager

Overpricing of a Subcontract for the B-1 Bomber Engine

Background

The Department of Defense (DOD) regulations covering the allowability of overhead costs charged to government contracts are contained in section 15 of the Defense Acquisition Regulations (DAR). Some of the unallowable costs are set forth in table I.1.

Table I.1: Types of Unallowable Costs

Description of the unallowable cost	DAR reference
The cost of media advertising including conventions, exhibits, and free goods that are related to sales promotion	15-205.1
Contributions and donations	15-205.8
Entertainment costs including costs of amusement, diversion, and social activities	15-205.11

Prime Contract Data

The Air Force and the General Electric Company, Aircraft Engine Business Group, Evendale, Ohio, reached price agreement for the prime contract on April 20, 1984. The contract number is F33657-84-C-2047 (formerly F33657-82-C-0269). This contract was a multi-year contract for the delivery of General Electric engines in 1985, 1986, and 1987 for the B-1 bomber program, at a firm-fixed price (with escalation) of $1.6 billion. The negotiated price of the prime contract included a multi-year subcontract proposal, by Mal Tool, for engine fan blades at a cost of $23,441,233.

General Electric's Analysis of the Subcontract Proposal

General Electric's analysis of Mal Tool's proposal concluded that for the most part the price was fair and reasonable. One exception was the cost of handling defective fan blades (scrap and rework), which was considered to be too high.

General Electric's analysis did not question any Mal Tool overhead cost items. The analysis referred to the results of past fact-finding visits to Mal Tool that had not identified any unallowable overhead costs. A General Electric official stated that the prior analysis was based on assurance from Mal Tool's Vice-President for Finance that Mal Tool's overhead did not contain any unallowable costs. The official claimed that Mal Tool's Vice-President for Finance would only permit access to summary level cost data and not to the detailed accounting records that would be necessary to fully analyze such costs. General Electric's analysis did not refer to the access problem.

Mal Tool's President stated that the access issue was never brought to his attention by anyone from General Electric, and had it been, he would have provided access to the requested records. The Vice-President for Finance has since retired from Mal Tool.

Questioned Costs Effect on Price to the Government

Table I.2 shows the cost items and the amounts we question. Mal Tool included these costs in overhead rate calculations for its multi-year proposal to General Electric. The overhead, plus an increase for anticipated inflation and Mal Tool's profit, were added to the cost of each fan blade. With the addition of General Electric's overhead and profit, negotiated by the Air Force, the price effect to the government caused by these costs amounts to $190,646.

Table I.2: Mal Tool Fiscal Year 1983 Subcontract Overhead Costs Questioned

Overhead cost items	Amount
Yacht in Florida	$94,432
Lodge in ski area of Vermont	39,585
Exhibit first used at Pratt & Whitney celebration and related costs	17,876
Hotel and related costs at a conference	14,097
Restaurant expenses for customers	6,033
Contributions and donations to various organizations	4,430
Golf club membership and tickets to sporting events	4,689
Total	**$181,142**

Yacht in Florida and Lodge in Ski Area of Vermont

Mal Tool's overhead costs included expenses for a 44-foot yacht maintained in North Palm Beach, Florida, and a lodge in a ski area of Vermont. Both items were recorded as sales promotion under general and administrative expenses and as depreciation under manufacturing overhead. Table I.3 shows the details of the yacht and lodge costs.

Table I.3: Yacht and Lodge Costs Included in Overhead

Yacht costs	Amount
Captain's salary, bonuses, and payroll taxes	$40,467
Marina fees, fuel, and operating expenses	39,237
Depreciation	14,728
Total	**$94,432**
Lodge costs	
Maintenance person's salary	$10,100
Depreciation	23,370
Operating expenses including property taxes	5,143
Liquor and soda	972
Total	**$39,585**

Mal Tool officials told us that they did not maintain any records of the use of the yacht or the lodge. They estimated that for 1983, both were used only about 10 times each by the parent company, Gulf & Western, and Mal Tool employees. Mal Tool officials stated that although some of the costs were charged as sales promotional costs, Mal Tool employees used the yacht and lodge for recreational purposes and not sales promotion. They believe that the costs should have been accounted for as employee morale benefits. They also noted, however, that Gulf & Western employees may have used the yacht and lodge for entertaining customers.

There is no documentation as to who, when, and for what purposes these facilities were used. The recollections of Mal Tool officials were vague. Regarding Mal Tool's position that these costs were really employee morale expenses for its approximately 240 employees, DAR 15-205.10 suggests that the morale benefits are of the type available to all employees and then states that employee benefit costs are allowable to the extent that they are reasonable. Based on the apparent use by other than Mal Tool employees, the infrequent use of these facilities, and the lack of documentation as to who could and did use them, we do not believe that Mal Tool has made a credible case that the noted expenses were either for employee morale purposes or reasonable.

In addition, given the nature of these facilities, the costs appear to be unallowable as entertainment costs under DAR 15-205.11, to the extent Gulf and Western personnel used the facilities. DAR 15-205.11 states that entertainment costs including the costs of amusement, diversion, and social activities are unallowable.

Exhibit First Used at Pratt & Whitney Celebration and Related Costs

Mal Tool's overhead costs included expenses for an exhibit, first used at the Pratt & Whitney "Open House" celebrating 25 years of business in Florida, that displays Mal Tool products. The costs also included amounts for sport visors and toy planes given to Pratt & Whitney's employees and guests. The exhibit cost $11,998 while the visors and toy planes cost $5,878. These costs were charged as promotional costs in Mal Tool's accounting records. Mal Tool officials maintain that these costs were allowable because the government benefited from the open house when government employees in attendance learned about Mal Tool products. In addition, the officials stated that the exhibit was intended to be used and has been used for functions other than the Pratt & Whitney celebration.

The promotional costs for the exhibit, the visors, and the toy planes appear to be unallowable. DAR 15-205.1 states that the cost of advertising by means of exhibits and free goods that are used for sales promotion, are unallowable. The regulation is very specific about the circumstances where advertising costs are allowable and none of these circumstances involves educating government personnel. Also, Mal Tool has presented no evidence that these sales promotion costs are allowable as selling costs under DAR 15-205.37.

Hotel and Related Costs at a Business Conference

Mal Tool's overhead costs included expenses for a 1 week business conference on power generation. These costs included hotel and related costs for entertainers, bartenders, and hostesses employed during the conference. Although the invoice detailing specific hotel charges was not retained, Mal Tool officials explained that the hotel costs covered the lodging costs of its two employees who attended the conference, and the costs of a hospitality suite, food, and liquor for its promotional activities. Table I.4 lists the hotel and related costs included as promotional costs in Mal Tool's accounting records.

Table I.4: Hotel and Related Items Included as Promotional Costs

Costs Included in Overhead	Amount
Hotel	$10,712
Entertainers (musicians)	1,425
Bartenders and hostesses	1,960
Total	**$14,097**

Mal Tool officials maintain that the costs should be allowable because the conference involved technical discussions and the government benefited because government employees attending the conference could learn, in the hospitality suite, about Mal Tool as a source of low cost engine parts.

We believe that the $10,712 cost for the hotel was an unreasonable cost for two Mal Tool employees attending a conference. We believe the majority of the hotel costs and the costs of entertainers, bartenders, and hostesses were entertainment expenses, unallowable under DAR 15-205.11.

Restaurant Expenses for Customers

Mal Tool's overhead costs included expenses for customers' meals at restaurants. Restaurant costs for customers amounting to $6,033 were identified as promotional costs in Mal Tool's accounting records. Mal Tool did not maintain any records indicating who received the meals or the purpose of the meals. Mal Tool officials explained that the customers were persons involved in the technical aspects of contracts, such as quality control, and not in the negotiation of contracts.

All of the restaurant costs appear to be unallowable. Although these costs were charged as promotional costs, they appear to be entertainment expenses which are unallowable under DAR 15-205.11.

Contributions and Donations

Mal Tool's overhead costs included $4,430 of contributions and donations. This amount was charged to the contributions account in the company's financial records. The contributions and donations included checks to various organizations and equipment to a trade school. Mal Tool officials do not agree that all of these costs were unallowable. For example, they claim that $2,270 for machinery donated to a trade school is actually a recruiting expense. Mal Tool officials believe that the donated machinery would increase its goodwill with the school, and that the school would recommend Mal Tool as an employer to students.

The entire $4,430 of contributions and donations are unallowable costs. We believe that they were correctly classified in Mal Tool's accounting records and were unallowable per DAR 15-205.8, which states that contributions and donations are not allowable costs. Moreover, DAR 15-205.33 lists the type of expenses allowable as recruitment expenses, and contributions of the type made by Mal Tool are not indicated. Finally, the amounts claimed for the donations do not appear to be reasonable

since a letter notifying the school of employment opportunities at Mal Tool could have accomplished the recruiting objectives.

Golf Club Membership and Tickets to Sporting Events

Mal Tool's overhead costs included expenses for a golf club membership for its Vice President of sales and tickets to sporting events, including a golf tournament and the Super Bowl. The golf club membership for $1,699, the tickets to the golf tournament for $2,750, and the Super Bowl tickets for $240 were all charged to promotional expense. Mal Tool officials did not maintain any records showing who used the tickets. They claimed that the tickets were used by its employees and not used for promotional purposes. They also stated that the golf club membership was an employee fringe benefit not incurred for promotional purposes. They maintain the costs were allowable expenses that had been misclassified as promotional expenses in the accounting records.

In the absence of additional information, we are not convinced that the golf club membership and tickets are allowable fringe benefit or employee morale costs. If these costs were promotional expenses as charged, there has been no showing that they relate to the marketing of Mal Tool's products or provide a reasonable benefit to the government as required by DAR 15-205.37.

Objective, Scope, and Methodology

Our objective was to determine whether Mal Tool included unallowable overhead costs in its subcontract proposal used by General Electric as cost or pricing data in support of material prices for the B-1 bomber engine contract.

We performed our review at Mal Tool and Engineering, Manchester, Connecticut; a division of Wickes Companies; the General Electric Aircraft Engine Business Group, Evendale, Ohio; the Air Force Aeronautical Systems Division, Wright-Patterson Air Force Base, Ohio; the Air Force Plant Representative Office, Detachment 28, Evendale, Ohio; the Defense Contract Administration Services Management Area, Hartford, Connecticut; and the Defense Contract Audit Agency Regional Office, Waltham, Massachusetts.

We reviewed contract file documents, negotiation records, overhead rate submissions, and related price proposals. We also interviewed contractor representatives and government officials responsible for procurement, contract administration and contract audit.

We limited our review of Mal Tool's subcontract proposal to selected overhead costs included in manufacturing overhead, and in general and administrative expenses totaling about $9 million.

Our review was performed in the months of March through July 1987, in accordance with generally accepted government auditing standards, except that the scope of our review was limited by the unavailability of invoices supporting the proposed overhead costs. Mal Tool's subcontract proposal was based on its fiscal year 1983 overhead costs. Mal Tool officials told us that the invoices for fiscal year 1983 were discarded due to limited office storage space. By discarding these invoices, Mal Tool failed to meet its contract requirements with General Electric, and with federal records retention regulations. Mal Tool was only able to obtain copies of several of the invoices we requested. Accordingly, some of the invoice details were either not available or were based on Mal Tool officials' recollections.

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.